Mandated Disclosures and Interest-rate Ceilings on Credit Cards: How the Patchwork of Legislation and the Design of Credit Card Contracts Undermine the Effectiveness of Regulation

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May 20, 2016 (Colloquium Draft Version)

Abstract

In several jurisdictions, rules on interest rate ceilings - usually treated under the concept of "usury laws" are an important part of the regulation of consumer credit, not without a constant controversy about the real benefits to debtors, especially those with fewer resources. At first glance, the Chilean regime of interest rate ceilings seems to be particularly robust since it considers four different legal sanctions if a lender charges a higher interest than allowed: (1) a criminal penalty, (2) a contractual sanction consistent with reducing the interest rate applicable to the operation, (3) an infraction of the Consumer Protection Act that enables the consumer-debtor to bring a civil liability case before the court, and (4) an administrative penalty imposed by the Chilean banking supervisor, the latter being incorporated in the most recent amendment to the act governing credit transactions of money, along with a new set of ceilings, based upon different amounts and types of loans. Notwithstanding the foregoing, and as we will discuss in this paper, in the case of credit cards, a review of some of the terms and conditions widely used in the market suggests that the design that suppliers have given their contracts, along with certain terminological vagueness in the regulation currently in force, provides scenarios of possible circumvention of the law. In addition, from a comparison between the substantive regulation of lending and duties of (mandated) disclosure of information in consumer credit contracts, we will highlight certain areas of discrepancy (if not downright contradiction) between these regulations that affect how consumers can perceive the costs associated with the use of credit cards.

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1 Introduction

Consumer credit is a particularly fertile ground for the analysis of consumer protection policies. First, because it is an area highly sensitive to the political and social beliefs of policymakers on the role that should be assigned to market forces to outline our daily lives. Second, because it is not surprising that several initiatives bent on regulating consumer credit emerge in the face of certain financial scandals or crises. Third, since several developments enshrined in so-called "financial innovation" are currently challenging the measures and instruments designed to achieve certain level of enhancement of consumer welfare. Finally, because it is often necessary to adopt a fresh — and sometimes disruptive— approach to the long-standing mercantile institutions present in our legal systems, even before the existence of the notion of "consumer" as a concept with legal significance.

Furthermore, the very idea of consumer credit as a regulatory topic is, to a certain degree, particularly vague. Does it have to do with the involved parties (a consumer and a provider)? The operation's amount and term? The type of financial product? The destination of the loaned funds? Indeed, each of these attributes, in one way or another, contributes to the creation of a scenario in which the legislator focuses on implementing, through public and private regulatory instruments, objectives covering both the economic interests of consumers, where over-indebtedness is a major concern, and promoting access to financial services; where the French term "bancarisation" is deeply rooted in the Latin-American context.

Notwithstanding the foregoing, there is sufficient consensus that credit cards are a hot issue in the regulation of consumer credit.

On one hand, because its use as an instrument of credit usually involves paying high interest and fees; a matter that deserves special attention in countries like Chile, with a maximum interest rate regime that is constantly evolving.

On the other hand, from the user’s perspective, despite their widespread use, credit cards have a complex nature, or better said, as complex as issuers wish it to be. Annual fees, charges per event, late fees, prepayment fees, segmented credit lines, loyalty programs, exclusive offers, cash advances, and consolidated loans in the event of a minimum payment are just some of concepts involved in the daily use of credit cards. Faced with this predicament, policymakers, motivated nowadays by advances in the field of...
behavioral economics, have chosen to design standardized instruments that are aimed to put consumers in a better position to figure out costs that initially seem hidden.

However well-intentioned such policing might be, when relevant price cap rules are not in tune with the duties of disclosure of information, as we will show, they can be harmful to consumers, particularly in markets with multidimensional prices, as in the case of credit cards.

This paper is organized into four sections, including this brief introduction. The second section outlines the main features of Chilean consumer credit regulation applicable to credit cards, particularly the mandated disclosures set forth in consumer legislation and the interest rate ceilings contained in substantive regulation on credit operations. The third section attempts to briefly portray the conflicts and current unresolved gaps between those regulations, given some examples of contract terms used by credit card issuers that show how they could take advantage of legal uncertainties. Finally, the fourth section, by way of conclusion, highlights some recommendations in order to carry out a review of current in-force consumer credit regulation, taking into account some insights by research in the field of behavioral economics.

2 Price caps on Loans and Duties of Mandatory Disclosure

2.1 Annual Percentage Rate and Total Cost of Credit

Information asymmetry between providers and consumers is one of the problems that underlie consumer relations under the traditional paradigm of consumer law. Before such a predicament, policymakers opt to incorporate legal regulations imposing information disclosure obligations on providers to have them inform certain aspects of their products or services.

Now, with regards to the mandatory disclosure of information to consumers, findings and experiences in the field of behavioral studies propitiate a paradigm shift, moving from total disclosure to selective disclosure, preferring to deliver synthetic and contextualized information in lieu of complete and generic information, contemplating in particular the effects of framing and other cognitive biases on consumer choices. Likewise, when evaluating credit products or loans, many consumers contemplate their nominal interest rates in order to decide on the most convenient. However, certain studies show that individuals do not include, in their cognitive capacities, the calculation of compound interests applicable to majority of such products.

Thus, according to the underlying theory, it would be useful to provide standardized information, represented in simple indicators, to better reflect a loan’s cost beyond those

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of the interest rate involved, allowing for comparison with other available offers in the market.

Regulations should therefore not only compel providers to reveal the information, but also have providers produce a particular type of standardized information that will enable consumers to make better decisions. One of such cases is the use of credit or loan cost comparison tools such as the Annual Percentage Rate "Carga Anual Equivalente" (APR).

The APR is a tool that enables one to compare, through a common point of reference, the financial convenience of various credit or loan products, enabling consumers to decide more efficiently than they would by comparing the informed interest rates.

Upon the reforms made to Law No. 19.496 on Consumer Rights Protection Act (CRPA) by Law No. 20,555 of 20111, the consumer is entitled to information on the total cost of the offered credit and the respective APR, submitting its calculation formula to a series of administrative regulations.

For credit cards, the calculation and types of APR have been defined in the Regulation on Credit Cards Information to Consumers - Decree No. 44/2012 of the Ministry of Economy (CCIR), as summarized in the following table.

<table>
<thead>
<tr>
<th>APR</th>
<th>Features</th>
<th>Document</th>
</tr>
</thead>
<tbody>
<tr>
<td>Reference APR (Article 3 N°29 CCIR)</td>
<td>There is an APR for each credit product: installment purchases, cash advances and revolving credit. Term: 12 Months. Amount: 20 UF. Includes principal, interest rate, opening fees, charges, maintenance fee, expenses and fees for any other voluntarily acquired service or product.</td>
<td>1. Non-binding estimation of contract; 2. Binding contract offer; 3. Standard Summary Sheet</td>
</tr>
<tr>
<td>Prepayment APR (Article 3 N°30 CCIR)</td>
<td>Term: No. payments. Amount: Outstanding Balance. Includes principal, interest rate, opening fees, charges, maintenance fee, expenses and fees for any other voluntarily acquired service or product.</td>
<td>Monthly Statement (prepayment section)</td>
</tr>
</tbody>
</table>

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1One should bear in mind that the first published APR experience in the Chilean legal system can be found in Law 20.448 of 2010, and in Regulation 1.1512 of the Ministry of Finance. Both instruments regulate what is referred to as universal credits ("plain vanilla loans"). Historically, the universal credits constitute one of the most disappointing experiences of pro-consumer intervention in the financial market, where the desire for standardization went beyond just information, leading to prior determination of the products' attributes.
As can be seen, without discussing the mathematical aptitude of the underlying formulas to each APR type, the greatest disadvantage associated with the implementation of the notion of APR on credit cards is precisely the very existence of various APR; an issue that affects its comparative nature. Think of the Advertising APR, for instance, which considers only the costs of the transaction itself. While it may allow for a quick comparison of products offered by different providers (e.g. advances in cash in an amount below CLP$100,000), it does not allow one to see the real dimension of the credits or loans in terms of their recurrent administrative costs (not contemplated in the formula), which are of considerable magnitude. For the purchase or payment of goods and services charged to a card, the comparison requires several requisites fulfilled; in order to decide on the best place to buy a TV, the Advertising APR, would only allow for a solution to the problem when comparison is made assuming the same value for payment in cash and the same schedule of installments.

Moreover, if “Reference APR” is the type of APR that includes all fees and costs associated with a credit card, it is difficult to understand that the card issuer is not expressly required by law to show a summary reference sheet on its website, thus allowing consumers, and third parties who maintain online product comparison platforms, to obtain and process that information.

### 2.2 Interest Rate Ceilings and Other Price Caps

Chilean legislation imposes at least three price caps associated with the granting of loans:

1. Maximum rate of interest referred as Maximum Interest Rate “Tasa Máxima Convencional” (TMC), which will be discussed below;
2. Caps on extrajudicial debt collection expenses; and
3. Caps on prepayment commission.

Before going into a more detailed review of the attributes of TMC, it would be wise to take a quick look at the last couple of price caps.

Extrajudicial debt collection, how it is done, and the limits for expenses charged thereof, are regulated in the CRPA. Such “expenses” plus default interests, are part of the charges associated with the late loan payment⁶.

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⁶In the case of credit cards both delinquent interest and debt collection expenses should be expressed in the “Late fees” section of the Standardized Monthly Statement Form (See. article 22 of ccnr).
According to article 37 of the CRPA, the lender, regardless of the form of management, frequency and effectively incurred costs, shall not charge extrajudicial collection fees that exceed the following ceilings: 9% for debts of up to 10 UF; 6% for the part of the debt that exceeds 10 UF and up to 50 UF; and 3% for the part of the debt that exceeds 50 UF. Such expenses may only be charged after 20 days default, and if not paid still, the interests charged shall not be higher than the current interest rate being likewise expressly forbidden any form of capitalization. The regulation also establishes that in the absence of effective collection management within the initial fifteen days of default the maximum applicable collection charges be reduced in 0.2 UF.

Notably, the above provision shows a clear tension between a purpose that extrajudicial collection charges be the means used by lenders to recover effectively incurred expenses and the fact that a price ceiling structure based on the debt amount is in practice an imposed system of limits on the charging of default penalties.

For its part, in the case of prepayment commission, the legal denomination is clearly at least confusing. Chilean law establishes, as a general rule, that the prepayment of a loan must be the result of mutual agreement between contracting parties. However, for transactions under 5,000 UF (≈ USD185, 000) the debtor may require to repay the loan even if the lender wishes otherwise. If the debtor intents to exercise the right to prepay the loan, s/he shall pay the principal (duly indexed, for indexed operations), the contractual interest calculated up until the actual payment date, plus a prepayment commission not exceeding one month's interest on the prepaid principal (for non-indexed operations), or a month and half of interest on the prepaid principal (for indexed operations). In any case, the respective regulation stresses that prepayments shall not be lower than 20% of the outstanding balance in debts prepaid without the lender's consent.

Obviously, a loan's prepayment, especially one of long duration, is a situation that is not necessarily beneficial to the lender, considering the lender's profit expectations in respect to that loan. When the law establishes a debtor's right to prepay a debt, in spite of the creditor's rejection, it does on the understanding that such situation deserves a different treatment from that of early contract termination due to a breach of contract (e.g. acceleration of debt repayment). However, notably, there is no service or expense on the lender's part associated with the debtor's intention to exercise a prepayment which needs to be particularly compensated, thus it is improper to refer to such charge as "commission". The so-called prepayment commission is nothing more than a prepayment penalty, which follows the law that entitles the lender to be compensated (with caps) for ultimately not earning what was expected of the loan operation.

This vagueness in the terminology, as will be addressed below, is incidental upon the ontological debate on financial charges and costs subject to the TMC.

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7 A UF (Unidad de Fomento) is a monetized daily unit of account indexed according to inflation. Most of the large sum loans are expressed in UF than Chilean Peso.

8 See Law No. 18.010 on Money Lending Operations (MLOA), article 10.
2.2.1 The Maximum Interest Rate Regulation

The very possibility of charging interest on monetary loans hinges on the (objective or subjective) determination of a threshold at which the interest rate becomes abusive or intolerable, when charging interest is permitted at all, and rules that address this issue have existed since ancient times in various cultures. Over time, several legislative acts have been designed and passed to regulate Interest-Rate Ceilings (IRC), including the Civil Code itself, and nowadays it is the MLOA which governs the legal treatment of money lending transactions, including the Civil Code itself, and nowadays it is the MLOA which governs the legal treatment of money lending transactions, including the applicable interest, rate ceilings, forms of computation, adjustment mechanisms, and other substantive aspects of the relationship between the lender and debtor; a relationship which is not confined to the legal concepts of ‘supplier’ and ‘consumer’ because this law constitutes a common standard for all credit transactions.

Regarding what the term ‘interest’ is understood to mean, the MLOA, without actually defining it, contains a rule of quantitative order which, in principle, is functional for the enforcement of interest rate limits.

En las operaciones de crédito de dinero no reajustables, constituye interés toda suma que reciba o tiene derecho a recibir el acreedor, a cualquier título, por sobre el capital. Se entiende por tasa de interés de una operación de crédito de dinero no reajustable, la relación entre el interés calculado en la forma definida en este inciso y el capital. En las operaciones de crédito de dinero reajustables, constituye interés toda suma que recibe o tiene derecho a recibir el acreedor por sobre el capital reajustado. Se entiende por tasa de interés de un crédito reajustable, la relación entre el interés calculado en la forma definida en este inciso y el capital. En ningún caso, constituyen intereses las costas personales ni las procesales.

Notwithstanding the disposition, in the harsh terms of its drafting, although it would seem to leave no doubt about what constitutes interest in a transaction, practical experience has shown that there is more of a problem in determining the nature of certain financial charges when applied in the context of recurring credit transactions.

As for the IRC, the MLOA has defined for this purpose a maximum rate applicable, the TMC rate that, according to the taxonomy used by Munzele and Henriquez has the following attributes.

1. It is a relative cap. The TMC does not consist of a percentage rate prefixed by the Law. On the contrary, it is determined as a percentage ratio based on the current

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11See MLOA, articles 3 and 5.
interest rate, that is calculated by the Superintendencia de Bancos e Instituciones Financieras (SBIF), and differentiated by indexation, the term of the loan, the transaction amount, and the currency’s denomination (domestic or foreign).

2. *It uses a endogenous benchmark.* The Average Interest Rate “Tasa de Interés Corriente” (TIC), which is the basis for determining the TMC, is a weighted average of the rate charged by banks per each segment of loans.

3. *It is based upon a combination of a multiplication coefficient and a numeric margin.* As a result of the reforms introduced in the MLFA by Law 20.715 of 2011, the calculation of the interest rate ceiling is determined by a multiplicative coefficient (as a rule both general and subsidiary) and an additive factor for certain types of loans. Thus, the new general rule states:

An interest exceeding the result of multiplying the corresponding principal and the greater of the following numbers shall not be agreed upon: (1) 1.5 times the TIC in force at the conclusion of the agreement, as determined by the Superintendency for each type of money lending operation, and (2) the TIC in force at the conclusion of the agreement, increased by two annual percentage points.

Nevertheless, in the case of loans of up to 200 UF for terms of over 90 days, the TMC is given by the following formula:

\[
TMC_t^{(50-200\text{UF})} = TIC_{t-1}^{(200-5000\text{UF})} + 14 \\
TMC_t^{(50-200\text{UF})} = TIC_{t-1}^{(100-5000\text{UF})} + 21
\]

As can be seen, for calculating the TMC for operations up to 200 UF two sections are contemplated. Each section is calculated based on the TIC for 200 to 5,000 UF of the previous month plus an additive factor. The special formula for low value loans was introduced by the Law No. 20,715 with the objective of reducing the current figures of TMC. This was done in order to meet a twofold purpose. The first is to prevent interest rates from going beyond what was necessary, where sometimes lenders take advantage of unpreparedness and lack of financial knowledge of many debtors. The second purpose is at the same time to take care not damage debtors by letting them without access to formal credit markets. This would lead them to accept loans granted by informal lenders where abuses are the norm rather than the exception.

As for the revolving lines of credit associated with credit cards, Law 20,715, as an innovation when contrasted with the previous system, introduces a specific rule for their interest rate calculation that is based on the term of the contract that gives rise to the line of credit and the maximum amount authorized therein. This is because, as was noted in the legislative debate surrounding the issue, it is difficult to determine the term of a revolving credit operation as there is, in principle, no predefined term for it.

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13See MLFA article 6°, par. fifth.
4. *It is not entirely clear whether this is a nominal rate or an effective rate.* This is because, despite the wording of article 2 of the TMC excerpted above, although it would seem to speak in absolute terms as to what should be considered interest, the inclusion of various financial charges is based on case-specific criteria contained in administrative regulations that addressed in some way this issue, that now are repealed.

Finally, with regard to the penalties for infringement of TMC, it should be noted that the MLOA provides for two types of individual sanctions against charging higher interest rates than are allowed: (a) a reduction in full of the agreed interest rate to the normal current interest rate; (b) a system of administrative penalties in which the SBIF may impose penalties ranging from reprimand/censure to fines of UF 5,000.

In order for the SBIF to exercise administrative oversight, when the granting of credit is not an activity that is, per-se, subject to prior licensing, and that the above-mentioned organization, on the basis of different laws, oversees only banks, credit unions and some relevant credit card issuers, the Law 20.715 brings the term of “Massive Lending Entities” into the picture. As a result, the operations of these institutions will be supervised by the SBIF. In the eyes of the law those entities shall be considered to meet the “Massive Lending Entities” criteria if they carry out transactions with an annual worth of at least UF 100,000, or carry out more than one thousand transactions annually.

Additionally to these sanctions it must be added the crime referred as “usury crime” incorporated into the Criminal Code and the sanction contained in the CRPA when a supplier charges a consumer an interest higher than the maximum (by means of a crossreference with MLOA).

### 3. The Effects of the Current State of Regulation of APR and Interest Ceilings in the Credit Card Market

As was pointed out above, as of today there are no legal criteria to determine which financial charges should be included in the TMC.

Notwithstanding that, previous administrative regulations, currently repealed, established certain rules applicable to this matter, which can be summarized as follows:

1. All amounts in excess of principal should be treated as interest.
2. Taxes, notary fees, costs of appraisal of property, and insurance policies should be excluded of the calculation.
3. If the fees are related to either complementary services or complex banking services different to money lending activities should not be part of the interest rate calculation.

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35See Criminal Code, article 472.
For the case of credit cards additional clarifications were made:

1. In general, in the case of regular services associated to the use of a credit card, issuers should not charge a commission different from the maintenance fee.

2. In the case of additional services, issuers are allowed to charge different fees. Cash advances are treated, notably, as additional services.

3. Fees shall not be charged as a percentage of a transaction, except for purchases abroad.

In our opinion, the above criteria are based on a disquisition we have called “ontological”, which in this context is the opposite of a finalist “regulatory purpose” analysis. In that sense, the commissions shall not be treated as interest, and consequently they will not be summed to the effective interest rate, to the extent that they are different from mere interest charges.

Such criteria were used by Servicio Nacional del Consumidor (sernac) to sue and reach out-of-court settlements with various non-bank issuers that were charging fees added to purchase transactions. The collection of these commissions, says sernac, is illegal because it does not related to the rendering of different services, and as a consequence these charges must be part of the calculation of interest. Thus, in case the issuer charges an interest set to the same current value of tmc, as is the case of several cards targeted toward low-income households, charging an (illegal) additional commission would breach IRC if applicable.

As a result of the above legal procedures, many card issuers changed their fee schedules, leaving in most cases only two commissions plus late fees: a monthly or semi-annual maintenance fee and a cash advance fee, which in turn were commissions not treated as illegal or part of tmc by sernac.

Using the concepts developed by Bar-Gill, credit cards are multi-dimensional products with multi-dimensional prices. In this sense, prices are typically associated with the acquisition cost of a card (e.g. maintenance charges) as well as with the intensity of the use of a card (e.g. interest and transaction fees).

In this context, according to Bar-Gill, the pricing policies may be useful to the extent that there is an misperception on the consumer's part of a particular dimension of the price.

Considering the above for the matter presented here, one can see that the new pricing structure used by some issuers combined usage patterns within typical charges associated with the acquisition of a card; price dimension that in accordance with the current state of the debate on the nature of the maximum conventional rate shall not be subject to price-caps.

Moreover, as we have seen, the duties of information in financial products allow providers to not expressly reveal maintenance fees in their advertising of "specific transactions."

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16 See sernac Circular No. 17, repealed and replaced by Circular No. 40.
Therefore, given the regulation’s own guidelines on the mandatory disclosure of information, the issuers can include a “transaction tailored APR” in their advertising, calculated without including administrative costs that are not directly linked to the transaction in question. Add to this the fact that, according to the actual state of the juridical discussion on the interest rate ceiling, annual credit card administrative fees should not include the effective fee of an operation in its calculation, the law – as a negative side-effect – is allowing the existence of a whole dimension of prices with low salience to the consumer, which is a fertile ground upon which to exploit consumers’ cognitive biases.

**Table 2:** A comparison of fees in credit cards contract of non-bank issuers. Source: Publicly available contracts.

<table>
<thead>
<tr>
<th>Issuer N°</th>
<th>Fees in previous Contract</th>
<th>Fees in Current Contract</th>
<th>Discount on Annual Fee</th>
<th>Information is being updated</th>
</tr>
</thead>
</table>

4 Conclusion

Regulation of APR and interest-rate ceilings are not in harmony. Worse, the lack of a comprehensive strategy of both has created spaces for consumer misperception and circumvention of the law.

The availability of different APR can be used by the supplier as an arbitration device. In the case of interest-rate caps it is urgent to adopt a systematic treatment for its scope. However, the purpose is not to solve the ontological discussion about the nature of interest, but rather to try to overcome it by evaluating if the regulation of disclosure rights over credit costs and the interest ceilings are effective, in relation to the objectives set in both regulations, i.e., to reduce information asymmetries, enabling consumers to learn the credit product’s true cost, while preventing low-income consumers from becoming over-indebted.

References


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